

OSA Newsletter

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Editor: Bob Baker

Private Pension Funds Rebound

In 2003, unfunded liabilities in the top 100 private retirement plans fell 41% thanks to a 72% increase in contributions and a 297% increase in returns. According to Pension & Investments review of annual reports in the July 12th issue (www.pionline.com), the unfunded liability of the 100 largest corporate pension plans stood at \$151 billion in 2002; at the end of 2003 it had fallen to \$88.7 billion.

- Only 3 of those firms reported positive returns in 2002, while only 1 firm reported negative returns in 2003.
- Among these top firms, only seven assumed they would earn over 9% long-term; most assume a rate of return in the mid-8% range.
- Twenty-three of the top 100 plans had funded status over 100%
- The plans with the worst funded status were airlines (United, Delta, and Northwest).

Elusive Alpha

"Alpha" is a term from modern portfolio theory to describe positive returns above the market benchmark.

On average, returns on assets, not contributions, provide the bulk of any retirement system's year to year gains. Most retirement plans experienced solid returns in 2003, and continue performing well in 2004. Not to be complacent, however, the California State Teachers' Retirement System (CalSTRS) has been investigating ways to boost alpha in its \$114 billion portfolio, according to the July 12, 2004 issue of Pensions & Investments.

CalSTRS has relied heavily on indexed funds and equities, which has made it one of the least expensive pension funds to operate. But concerns about meeting its 8% long-term assumed rate of return has the nation's third largest pension fund exploring alternatives to its current investment strategy. The numerous strategies being proposed include an even more active management of its public equities, rather than the passive strategy currently employed via enhanced stock-index funds.

Alan J. Brown, Group Chief Investment Officer at State Street Global Advisors, sees a danger in using these strategies. Picking better than average managers is very difficult to do in practice. With so much money chasing alpha strategies, many funds will lose their potential to deliver the desired returns. According to Mr. Brown, such strategies may be an effort to avoid the inevitable -- increasing contributions and saving more.

Pensions & Investments, July 12, 2004
State Street Global Advisors, Point of View, April 2004

Public and Private Retirement Plan Trends

The movement towards defined contribution plans has been predominantly a private sector trend while defined benefit plans still are the most prevalent retirement design in the public sector. Numerous comparisons between public and private pension characteristics were made in the June issue of Pension Benefits, Vol 13, number 6, (www.aspenpublishers.com) in an article from the Nationwide Retirement Education Institute.

Defined benefit plans currently cover 58 million workers in the United States -- 17.2 million of those workers are in the public sector. Despite the large majority of private sector workers in DB plans, over 53% of all DB plan assets are in public sector plans.

The contrast in worker characteristics show that public sector employees are more likely to be female, older, and have higher incomes (see Table). In addition, public sector workers are likely to be longer tenured with their employers than private sector workers.

Characteristics of Public and Private Workers		
	Public	Private
Female	56%	45%
Over Age 35	74%	61%
Avg. Annual Wage	\$40,228	\$38,322

Tide Turned or Just a Ripple?

The near-universal shift from private defined benefit to defined contribution plans has seen its first pause. As reported in the August 23rd edition of Pensions and Investments, several plan sponsors in the United Kingdom have scrapped their defined contribution plans in favor of defined benefit or hybrid plans.

The Marylebone Cricket Club and the Grosvenor Estate have both closed their defined contribution plans and replaced them with final-salary plans guaranteeing pensions based on annual pay of up to £25,000 and £30,000 respectively. Employees earning over these amounts may contribute to a supplemental DC plan to increase retirement savings.

Barclays PLC shuttered its DC plan after participation had fallen to 30% of its 25,000 members. Now members participate in a hybrid plan that provides 20% of the career average

salary upon retirement, with a self-directed DC plan in which Barclays matches employee contributions.

Not So Long Longevity

Longevity is an important issue of any pension discussion. It directly impacts how long a retiree could be expected to receive benefits. As of 2000, the average 65 year-old U.S. male could expect to live another 16.5 years. The average 65 year-old U.S. female could expect to live another 19.4 years.

Compared to the 30 other nations within the Organization for Economic Cooperation and Development (OECD), U.S. life expectancy is rather ho-hum. These findings, and analysis on factors related to longevity, can be found in a report released by the Center for Retirement Research at Boston College (www.bc.edu/crr) titled Why is Life Expectancy So Low in the United States? The report examines incomes, consumption habits, pension benefits, and health care. The report shows that U.S. citizens smoke and drink less than the OECD average, but lead in the share of population considered obese.

Pension Funding Equity Act

Pension plan funding is affected by the relationship of plan assets and liabilities. A private plan's "Current Liability," is based on IRS-prescribed interest rates. Until now, that rate had been based on an average of 30-year Treasury bond rates. The Treasury no longer issues 30 bonds, favoring instead lower-interest, shorter-term securities. This has been a problem for private retirement plans. Lower interest means higher retirement contributions. The Pension Funding Equity Act temporarily replaces the 30-year Treasury bond rate with a composite long term corporate bond rate for

plan years 2004 and 2005. Private plans will be able to determine their Current Liability using a higher interest rate. For example, plans that have a “calendar plan year” will value Current Liability at 6.55%. Without these changes, the rate would have been 5.51%. Accelerated contributions that would have otherwise been required for 2004 and 2005 will be reduced or eliminated.

This latest federal pension law also allows use of the composite long term corporate bond rate to calculate premiums paid to the Pension Benefit Guarantee Corporation (PBGC). How much of a private firm’s retirement fund contributions are tax-deductible will still be based on 90% to 105% of the 30-year Treasury rate.

The law also provides pension funding relief for airlines (see first article) and steel companies.

This act is effective through 2005.

Compliance Bulletin, April 2004, The Prudential Insurance Company of America and Watson Wyatt Insider, May 2004

GASB Issues Postemployment Benefit Accounting Requirements

The Governmental Accounting Standards Board (GASB) has issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which addresses how state and local governments should account for and report their costs and obligations related to postemployment healthcare and other nonpension benefits. Collectively, these benefits are commonly referred to as *other postemployment benefits*, or *OPEB*.

GASB is the independent, not-for-profit organization formed in 1984 that establishes and improves financial accounting and reporting standards for state and local governments.

The statement generally requires state and local governmental employers to account for and report the annual cost of OPEB and the outstanding obligations and commitments related to OPEB in essentially the same manner as they currently do for pensions. Annual OPEB cost for most employers will be based on actuarially determined amounts that, if paid on an ongoing basis, generally would provide sufficient resources to pay benefits as they come due.

For more information visit www.GASB.org.